

## **The Bulgarian Economy in 2006**

(Summary of the report by the Center for Economic Development)

- Total economic growth continues at relatively high values and in 2006 we expect it to stand at about 6.5 per cent on a year over year basis.
- Following an upward trend over the whole 2006, in the first month of 2007 the ESTAT index of business climate registers record-breaking growth up to 8.5 percentage points.
- In 2006, productivity registers lower growth compared to employment which increases at a twice higher pace against 2005.
- In 2006, foreign direct investments to Bulgaria exceed EUR 3.5 b and cover the current account deficit at 106.2 per cent.
- The tendency of higher growth in imports against growth in exports has been broken.
- In 2006, total increase of consumer prices stands at 6.5 per cent (December 2006 on December 2005) and is most notable in the group of non-food goods. In 2007 we expect accumulated new inflation of about 6 per cent.
- The lower, down to 10 per cent, corporate tax rate since 1 January 2007 deserves a very positive assessment but budget redistribution remains at very high levels and on an upward trend.
- The problems of labor force qualification and education as a whole are aggravating.
- The financial system develops on a success path with capital market registering notable growth of indexes and higher number of initial public offerings.
- No progress is registered in the reform and improvement of the quality and efficiency of the healthcare system.
- The lack of knowledge and skills in the public administration and the business to absorb resources from the EU structural funds raises concerns.
- In a sectoral aspect, accelerated growth in industry can be given a positive assessment whereas deteriorated railway transport and lower growth in tourism against the same period of last year are annoying.
- Some revival is noticed in agriculture but it is insufficient when viewed against total economic growth.

## Macroeconomic Dynamics



GDP

In 2006, the Bulgarian economy registers relatively high and stable growth. In the first nine months of last year **total economic growth** stands at 6.3 per cent and is up 0.7 percentage points on 2005. Conjuncture data for the last months of 2006 remain optimistic. **We expect economic growth to move around 6.5–6.8 per cent and 2006 annual growth to stand at about 6.5 per cent.**



Business  
climate

Accelerated **business climate improvement** observed in early 2006 slowed down in the last months but the indicator still remains at levels by more than 25 percentage points above those at year start. **In 2006, industry and trade were most contributive of general business climate indicator's improvement.** Like in previous years, the dynamics of business climate in industry sets the trend of the general business climate in the economy. Notable among the sectoral changes of the business climate in 2006 is the dynamics of the business climate in trade indicator which in mid 2006 for the first time since 2001 went above its long-term value of a little below 30 per cent and in the second half of 2006 remained at levels by more than 20 percentage points above that value. **The optimistic expectations about high economic growth in late 2006 and early 2007** are supported also by the fact that, unlike previous years, in all four industry sectors included in NSI's business surveys the business climate values at end 2006 are notably higher against end of 2005 values. Short-term industry dynamics indicators which are steadily moving upwards also support these expectations. **Industrial capacity load remains on an upward trend despite** that in October improvement is smoother compared to the record-breaking values in July 2006.



Industrial  
capacity  
load

In 2006, both industrial production and industrial sales increase at a higher pace compared to 2005. **Export sales increase at a notably higher pace compared to domestic sales and have sustainable and prevalent contribution in 2006 industry growth.** It should be noted, however, that growth in export sales registers a downward trend over the year whereas domestic sales are on an upward trend.

NSI's November survey data about the expected investment activity in industry indicate that **the Bulgarian industry has good potential for accelerated growth in 2007 as well.** The last survey for 2006 conducted among industrial enterprises projects 2007 nominal growth in investments at 16.4 per cent or up 5 percentage points on the 2006 estimated nominal growth in investments of 11.0 per cent.

On the **supply** side, *the industry sector* is operating at the highest and accelerating pace and the value added generated by this sector in the first nine months of 2006 is up 9.8 per cent on the same period of 2005 when it registered growth of 7.7 per cent. **Most contributive of accelerated**

↑  
Accelerated  
growth in  
industry

**growth in industry is industrial production** which registers more accelerated growth against the sector as a whole (12.2 per cent) whereas **growth in construction went below the two-digit values** registered since 2004 and now stands at 7.9 per cent. Two focal points can be highlighted in respect of industrial production. Mining and quarrying preserves a two-digit though delayed growth (down from 34.9 per cent in the second quarter of 2006 to 24.8 per cent in the third quarter of last year). **On the other hand, in the third quarter of 2006 growth in manufacturing has accelerated twice** to 13.7 per cent against 6.1 per cent in the second quarter of 2006 and 5 per cent in the third quarter of 2005.

Growth  
in services  
↓

On the production side, *services* remain most contributive of GDP growth (2.8 percentage points in the first nine months of 2006), but the **delayed growth in services** observed since the second quarter of 2006 persists – in the third quarter of 2006 real value added growth is 5.8 per cent against 6.2 per cent in the same period of 2005.

**The long awaited growth in the value added of the agrarian sector was registered in the third quarter of 2006**, up 0.9 per cent on the same period of 2005.

↑  
Private sector  
value added

Until mid 2006, growth in *the private sector* was by about two percentage points slower compared to the same period of 2005. However, in the third quarter **growth in its value added accelerated** to 8.5 per cent against 5.8 per cent in the same period of 2005 and 7.3 per cent in the second quarter of 2006.

On the **demand** side, most contributive of 2006 total real economic growth is the high growth in *investments*. In the first nine months of 2006, real growth in investments in equity stood at 18.9 per cent against 17.8 per cent on an annual basis for the same period of 2005. However, in the third quarter of 2006 growth in investments was by some 5 percentage points slower (against about 20 per cent in each of the previous four quarters) which probably indicates somewhat calmed down pace of investments total for the economy. Total economic growth of 6.3 per cent in the first nine months of 2006 is formed by a contribution of 11 percentage points of internal demand and a negative contribution of 4.6 percentage points of foreign trade in goods and services. *Consumption* remains most contributive of total economic growth on the demand side. It accounts for 5.3 percentage points of economic growth despite its slower pace of increase in the first nine months of 2006 against a year back (6.1 per cent compared to 7.3 per cent in the first nine months of 2005). The contribution of gross capital formation is 5.7 percentage points (including 4.2 percentage points accounted for by investments and 1.5 percentage points accounted for by the dynamics in stocks). The negative contribution of net exports is formed by positive contribution of exports of 6.6 percentage points and negative contribution of the imports of goods and services of 11.2 percentage points. It is important to note that in the first nine months of 2006 **net exports have**

↑  
Higher growth in  
exports against  
growth in Imports

**lower negative contribution compared to 2005** and even compared to 2003 when it was respectively 5.8 and 4.9 percentage points. Very likely, annual data will confirm this tendency of lower negative effect of foreign trade on economic growth.

Over 2006, the share of the negative foreign trade balance of goods and services was down 10 percentage points from one-fourth in the first quarter to 15 per cent for the first nine months of 2006, but remains at higher values compared to the same period a year back when it stood at 13.5 per cent. The shrinking negative share of the foreign trade balance of goods and services is attributable to accelerated growth in exports and delayed growth in the imports of goods and service compared to growth in the same period of last year. **In the first nine months of 2006 growth in exports is 10.5 per cent against 6.7 per cent in the same period of 2005 and growth in imports stands at 14.7 per cent against 15.2 per cent in the first nine months of 2005.** Thus the negative contribution of net exports in total economic growth was decreased from negative 7.3 percentage points in the first quarter to negative 4.6 percentage points in the first nine months of 2006 and stands below the annual value for 2005 (5.8 percentage points).

High current  
account deficit



**In the first eleven months of 2006<sup>1</sup> the current account deficit is up 55 per cent on the same period of 2005, at EUR 3 115 m.** The current account deficit ratio to annual GDP amount is up 12.9 per cent, deteriorating by 3.5 percentage points against the same period a year back (9.4 per cent). As usual, the deteriorated current account deficit is mostly attributable (60 per cent) to a deteriorated negative trade balance (deterioration of EUR 665 m) and the other portion is attributable to a continuing downward trend in the positive balances of other items – Income (down EUR169 m), Current Transfers (down EUR 140 m) and Services (down EUR 129 m). However, notable for 2006 (unlike 2005) is the fact that the relative deterioration of the trade balance has significantly lower unfavorable effect on current account's relative deterioration compared to a year back. Over 2006, this effect is even decreasing but at the same time the negative effect of the deteriorated positive balances in services, income and transfers is increasing at a high pace.

The shrinking negative contribution of *foreign trade balance* in the current account deficit is attributable to **accelerated growth in exports and delayed growth in imports since mid 2006**. In the first eleven months of 2006 growth in exports stands at 27.9 per cent on an annual basis against 18.4 per cent in the same period of 2005, and growth in imports is delayed to 24.6 per cent against 27 per cent in the first eleven months of 2005. The deteriorated positive balance in *services* for the first eleven months of 2006 against the same period of 2005 (down from 3.4 per cent to 2.5 per cent of

---

<sup>1</sup> Source: BNB, Balance of Payments published on 16 January 2007. Ratios are calculated taking the 2005 gross domestic product (NSI's preliminary estimates) of EUR 21 447.7 m and a 2006 estimate of EUR 24 199 m.

↑  
FDI cover the  
current account  
deficit

GDP) is mostly attributable to a deteriorated positive balance in the item Travels, down from 4.2 to 3.6 per cent of GDP. 2006 foreign tourism dynamics is unfavorable for the national balance of payments because revenues from travels of foreigners to Bulgaria increase at a slower pace (4.4 per cent) against Bulgarians' spending for travels abroad which in the first eight months increased by 13 per cent.

**In the first eleven months of 2006 foreign direct investments to Bulgaria stand at EUR 3.3 b and not only cover but also exceed the current account deficit by 106.2 per cent.**

The Bulgarian economy is of an open nature and develops under the direct influence of international conjuncture manifested in *foreign trade* and the inflow of FDI. Relatively good global economic development in 2006 determines growth in foreign trade by 26 per cent and significant inflow of FDI to Bulgaria (estimated at EUR 3.5 b for 2006). High domestic consumption and accelerated growth in industrial production, the opportunities opened up for inflow of European funds and a relatively favorable international conjuncture create conditions for sustained accelerated growth in the exports of goods (above the current value of about 28 per cent) and delayed growth in the balance of trade deficit (below 20 per cent annually). Expected stable national economic growth after Bulgaria's accession to the EU and investors' confidence in sustained fiscal discipline will keep high the rate of return on investments and the inflow of FDI will remain at least at its current level. This means increased supplies of investment goods for new and expanding production capacities, and of necessary raw materials. On this basis, **growth in imports will persist, but the tendency of exports increasing at a higher pace will be confirmed.** The reason is that some productions with invested foreign capital are export oriented and are directly connected with growth in imports. Investments in advanced technologies and equipment will certainly result in improved production competitiveness and wider export opportunities.

Bulgaria is already established on the capital flows map and still attracts the attention of foreign investors. **In 2007 the volume of FDI is expected to remain at about 12–15 per cent of GDP.** Based on set up investment projects and announced investors' plans, one can expect that investors' interest in Bulgaria will persist in the next two years. In the future, a significant part of projects will be focused on expanding production capacities, building the missing production process links, including storage facilities and logistics centers, transport terminals and other auxiliary facilities. The full investment potential has not been reached yet, as indicated by the non-subsiding investors' interest.

Significant  
increase in  
consumer prices  
↓

In the past 2006 total increase in *consumer prices* is 6.5 per cent (December 2006 on December 2005). Most significant is the price increase in the group of non-food goods (up 11.3 per cent) which is contributive of more than half of total accumulated inflation (3.4 percentage points). Foods are the

next group most contributive of accumulated inflation (2 percentage points) with price increase in this group standing at 5.4 per cent.

However, increase in food prices is determinative, in terms of its amount and contribution, of last year accumulated total increase in the prices of the specially monitored by NSI socially useful and vital goods and services<sup>2</sup>. Besides, the rise in the prices of the foods in this basket - 7.9 per cent, is significantly higher (by 2.5 percentage points) compared to that of the foods in the big basket. It contributes 4.6 percentage points to total price increase in the small consumer basket from December 2005 till December 2006 which stands at 5.4 and is lower than the inflation of prices in the big consumer basket.

Total increase of *producer prices (export and domestic market)* accumulated till November 2006 is 9.3 per cent against December 2005. Domestic prices move up at a slightly slower pace. Accumulated increase from the beginning of 2006 till November is 7.4 per cent. Compared to a year back (November 2006 against November 2005) total producer prices have increased by 10.5 per cent and domestic market prices are up 8.1 per cent. Following international price dynamics, metal ore mining (total increase of 80 per cent, increase in domestic market prices – 87 per cent) and metal production and casting register the highest price dynamics. Prices of tobacco products move slightly down both on an annual basis and since year start. In most of the other industry sectors the price increase does not exceed 10 per cent.

NSI's business survey conducted in December does not reveal synonymous conjuncture indications of expected change in consumer prices in the first months of 2007. On one hand, inflation expectations in retail trade are on an upward trend, and on the other hand, most of the enterprises in the services sector (74 per cent) do not project changes in the prices of the services they offer. According to the survey, producer prices in industry will probably remain unchanged. Most sensitive towards expected price increase is construction where inflation expectations are high and continue on an upward trend.

**The 2007 price dynamics will reflect continuing changes of administratively regulated prices and the adaptation of Bulgarian producer prices to the EU.** Government-planned adjustments of excise on fuels and VAT on schoolbooks and lawyer and notary fees will have a *pro-inflationary effect*. Similar effect will have the implementation of the Common Agricultural Policy, but it will probably be exhausted in one year. Implementation of the Single Customs Policy is expected to have an *anti-inflationary effect*. We will be seeing also difficult to project short-term attempts for speculative appreciation. However, such attempts could only

---

<sup>2</sup> This is the so-called small consumer basket of 100 specially chosen goods and services, weighted with the expenditures of the 20 per cent of the lowest income households. The 2006 big consumer basket contains 531 goods and services.

spread within solvent demand (mainly in respect of market services) whose growth will accelerate in a longer perspective. The price dynamics of the small and big basket will be indicative of how price changes will be absorbed by Bulgarian households. We have rather conservative expectations about the dynamics of inflation to be accumulated till end of 2007, which will probably move around its 2006 value (6.5 per cent).

**In 2006, employment increases at a twice higher pace against the previous year.** Over one year (from the third quarter of 2005 till the third quarter of 2006) the labor force in the Bulgarian economy increased by 100 thousand people, owing to growth in the number of employed person by over 100 thousand people and slight decrease in the number of unemployed persons (2.5 thousand). This means that the economy has managed to generate jobs for people who for some time have been off the labor market. This is evidenced by the fact that the number of discouraged persons (people who want to work but are not active in looking for jobs and therefore do not belong to the labor force) is down by 79 thousand people.

**Migration of labor from the public to the private sector continues.** Growth in private sector employment (125.7 thousand people), which is higher than growth in employment total for the economy (102.7 thousand people) is accompanied by decreased number of public sector employees, down almost 16 thousand people.

**In 2006 growth in productivity is lower compared to growth in employment and registers delay.** Economic growth in the first nine months of 2006, which is 6.3 per cent, is rather attributable to growth in employment (3.8 per cent) than to growth in productivity (GDP per employed person) (2.5 per cent), in contrast to the situation in the first nine months of 2005 when economic growth (5.6 per cent) was achieved with slower growth in employment (1.9 percent) compared to growth in productivity (3.6 per cent).

Slower *decrease in unemployment* on an annual basis (down 7.3 per cent in the first nine months of last year against decrease of 16.6 per cent in the first nine months of 2005) indicates that the potential of matching the labor supply by unemployed persons and the labor demand in the economy is somewhat exhausted. However, because of the faster growth in employment, the number of employed – number of unemployed ratio registers sustainable improvement. In the first nine months of 2006 one unemployed person accounts for an average of 9.9 employed persons against 8.9 for the same period of 2005. Unemployment coefficients continue downwards. Total unemployment is down from 9.2 to 8.8 per cent and more than one year unemployment decreases from 5.7 to 5 per cent of the economically active population aged 15+. Unemployment of young people between 15 and 24 years also decreases from 20.5 to 19.4 per cent.



Employment

Lower growth in  
productivity  
compared to growth  
in employment



## ESTAT Index of Business Climate

Entrepreneurs' opinions remain in steady harmony with objective economic condition indicators. **January 2007 results give us grounds to believe that the business environment is improving on a continuous basis.** Having registered high values over 2006 and showing indications of increase, in the first month of 2007 the ESTAT index of business climate moved up to the record-breaking 8.05 points. If this dependence persists in 2007, we can expect that the ESTAT index will go above the 10 points mark.



In January, the Company Component of the ESTAT index stands at 15.45 points – the highest value in indicator's five-year history. In contrast, the Investment Attitudes Component registers lower value than the average one for the period 2002-2004 (a little above 30). The third component of the index, Business Environment, remains at autumn of 2006 levels.

Assessment of the consequences of EU membership is direct corollary of the condition of companies and the evaluation of perspectives. Fifty-two per cent of the managers of poorly doing companies are extreme eurosceptics and maybe even membership opponents. In contrast, 80 per cent of the managers of prospering companies are enthusiastic about the opportunities opening up since early 2007.

Assessments differ also in terms of business fields. The share of optimists in industrial companies is up 10 per cent compared to their share in the companies in agriculture and services.

Results register increasing "discrepancy" between "prospering" and "drowning" companies. The number of companies in good and improving condition is up from 15.9 to 20.4 and of companies in poor condition – up from 3.7 to 5.7 per cent. Most unfavorable – with almost equal distribution – is the ratio of the economic subjects in the agrarian sector. The situation with industrial companies is just the opposite – 25 per cent of these companies can be characterized as prospering against only 3 per cent drowning.

The bad news, if any, from this survey obviously concerns the quality of human resources. **While in the past and the beginning of this decade personnel quality was among the few prides of entrepreneurs, today employers' attitudes are moving towards the opposite pole.** The current survey shows that the share of employers who can easily find the workers and employees they need barely exceeds one-third. To compare, in July 2002 this share stood at 60 per cent.

Most likely, business skepticism about labor force quality is intensified by competition on European level and increasingly embarrassing comparisons of the qualification and skills of Bulgarians to those of personnel in the older EU members. We can be sure that the negative trend registered by the survey describes a real and aggravating problem and not an imaginary one. **In the next years human resources may well become the Achilles' heel**





**of Bulgarian competitiveness if radical changes fail to be brought in the state policy on education, in the attitude of mind of young people and in company strategies.**

### **Economic Policy**

*Enterprise policy.* In 2006, efforts to improve the environment for business and entrepreneurship continued. A new Law on Commercial Register was passed, to take effect from July 2007. According to it the registration of companies is transferred from courts to the Registry Agency, thus making the procedure an administrative one. From the beginning of 2006 the National Revenue Agency provides integrated collection of taxes and social security contributions, facilitating entrepreneurs and citizens.

In November 2006 the Government approved changes to the Law on Investment Promotion. According to these changes, in the future incentives will be directed for promotion of investments in manufacturing, wider use of renewable energy sources and high-tech productions. Special focus is placed on labor force education and qualification. Changes were made also to the Law on Public Procurement towards greater transparency of appeal procedures.

Many economic  
regulations



**While some improvement is registered, there is also a need to take proactive measures in respect of economic regulations.**

**This sphere witnessed few positive developments in the past years.** The condition of regimes is studied and analyzed on a continuous basis, but that fails to produce specific actions towards facilitation. The passed Law on Simplifying Administrative Regulation and Administrative Control of Economic Activity remains non-operational; the tacit consent principle fails to be applied, etc. Municipal administrations still introduce licensing regimes and wrongfully collect charges, procedures remain slow and expensive. Monitoring and control of regimes is “scattered” among various ministries and institutions. Everything above said still creates problems for entrepreneurs.

Structural  
reform



**Considering structural reform, 2006 also failed to bring prompt measures for restructuring of the state monopolies and further liberalization of the energy and gas markets. No progress is registered also in the privatization and concession concepts in the transport sector and in the concepts for restructuring or liquidation of loss-generating state companies in the sector.**

Increasing  
budget  
surpluses



*Public finance.* In the past year public finance was characterized by stability and persistence of major trends established in previous periods. **Among these are: increased actual quota of reallocation through the budget, sustained chronic budget surpluses, and strengthened role of the state in the Bulgarian economy. Besides, these trends are not typical for**

**Budget 2006 alone, they will intensify in Budget 2007.** The coefficient of reallocation through Budget 2007 is planned at 41 per cent, up one percentage point on the figure planned in Budget 2006, but the real value may well go above 43 per cent. Subsidies for the Ministry of Economy and Energy have increased 13 times and those for the Ministry of State Policy for Disasters and Accidents – 12 times.

Since 2003 the government pursues a steady policy of accumulating budget surpluses towards curbing the balance of trade deficit and the deficit in the current account of the balance of payments. Despite the long period of implementation, this policy has failed as yet to produce the desired results – deficits are on a steady upward trend and the economy bears an extra tax and social security burden which obviously limits its export potential. The ruling coalition gives no indications as to how long this policy will continue. Obviously, it has to be stopped, but it is not clear when and the coalition also fails to provide and make public comprehensive reasoning of financial stability problems in Bulgaria. In this sense, the fiscal policy is actually “moving with stream”.

**Fiscal surpluses are channeled to the fiscal reserve which at end of November 2006 amounts to unprecedented BGN 6.7 b.** The three major macroeconomic problems connected with the growing fiscal reserve include: (1) there is no evidence whether the fiscal reserve is effective in counteracting the growing money supply, (2) it is “dead” capital which, if going in private hands, would intensify Bulgarian economic growth, and (3) it provokes the ruling towards spending which is not necessarily economically effective. Positive in this respect is the use of the fiscal reserve for redemption of the foreign debt, although this policy could be more trenchant. A matter of particular concern is the prospective use of the fiscal reserve in the Belene NPP venture.

**In 2006, the most positive change in the fiscal policy was the lower corporate tax, down from 15 to 10 per cent, in effect from 1 January 2007.**

*Social and health policy.* **In 2006, major positive trends of employment accelerated – unemployment decreased, incomes increased,** creating better prospects for closing the gap between Bulgaria and the other EU members.

Eliminating the transferability of the length of service allowance – a major recommendation in respect of Bulgarian labor market’s flexibility in EU’s latest monitoring reports – remained in a preparatory phase till year end. **The mechanism for payment of the length of services and professional experience allowance has been coordinated with the social partners, but still it entails potential conflicts.** Possible contradictions in the process of future negotiations between employers and syndicates on the amount of wage allowances may well delay its practical implementation.

**The lower social security burden, down 6 percentage points, preserved its sustainable positive effect on the collection of social security contributions till year end. Business representatives showed active**

↔  
Growing  
fiscal  
reserve

↑  
Lower  
corporate  
tax

↑  
Reduced social  
security  
burden

support of the idea to lower the pension contribution rate by another three percentage points in 2007, but still the measure was deferred for six months. The lower social security burden is not the only factor for the growing social security deficit which accounts for 37 per cent of expenditures. A number of measures which will increase the expenditure part of the budget have been introduced. Among these are: longer period in which maternity allowances are payable, and unemployment benefits for old age unemployed.

**Repeatedly delayed structural reform in hospitals**, called “optimization, restructuring and privatization of the hospital network” in the four-year government program, did not take place in the past year. Consequently, hospitals still accumulate debts, though at a slower pace compared to 2005. In the last quarter of 2006 outstanding liabilities reached BGN 160 m. The 2007 National Framework Contract became a confrontation field for the negotiating partners because the Law on the Budget of NHIF expanded significantly NHIF’s regulatory functions. Meanwhile, consolidated public healthcare expenditures remained at extremely low level as a nominal value – EUR 150 per capita which is significantly below the average EU level.

↓  
Lack of health-  
care reforms

*Environmental policy.* In 2006 the environmental factor became an important element of the business plans and strategies of Bulgarian companies. The entry of new financial instruments and intensified administrative control on the implementation of environmental standards were a decisive impetus for companies to look for their own strategic solutions, not relying on grants from international organizations and European funds. Based on the bilateral agreements under the Kyoto Protocol, Bulgarian companies implemented successful projects with significant environmental effect. Some successful forms of business – government institutions dialogue have been established (for example for waste utilization). **Bulgarian companies were admitted for participation in the European emission trading schemes.** Besides successful practices, there are also some problem areas for business representatives and government institutions. Centralized financing of environmental activities and a stronger formal and administrative approach gave rise to serious conflicts between the state and companies in different economic sectors, which in the past year failed to be settled to the satisfaction of all parties concerned.

Underefficient  
implementation  
of environmental  
legislation



**Government institutions remain underefficient in implementing environmental legislation at local level.** The economic instruments, which in 2006 had the task to ensure fulfillment of undertaken commitments under the European environmental directives, did not play significant role in improving the public services concerned with environment protection and preservation of natural resources. **In the absence of real competition and incentives for consumers and service suppliers, the prices of water**

protection, cleanness of towns and villages and energy efficiency services remain unreasonably high with very low social effect.

## Financial Sector

*Banking sector.* Over 2006, the credit expansion of commercial banks continues, although growth in macroeconomic aggregates (on an annual basis) decreases. In the last quarter of 2006 growth in broad money stands at 0.6 per cent and is lower than the average value (2 per cent) registered in the past 12 months. In November, domestic credit, which is a major component of net domestic assets, registered new peak value since the beginning of 2006. The value of the money multiplier is still varying, registering moderate growth in the last quarter of 2006. In December ECB (the European Central Bank) raised interest rates by a quarter-point, from 3.25 per cent to 3.50 per cent, which is expected to result in higher interest rate on most credits in euro in Bulgaria. Intensive competition on the banking market will keep interest rates on new credits at the same levels and even lower.

↑  
Interest rates  
on new credits  
will decrease

The tendency towards consolidation of commercial banks registered in 2006 will persist in 2007 with the merging of Bulbank, Hebros Bank and HVB Bank Biochim. The new bank grouping will be called UniCredit Bulbank and will displace DSK as the biggest Bulgarian bank.

At the end of 2006 BNB amended Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss. The two amendments restore Ordinance No. 9 to its 2005 version. Amendments to Ordinance No. 9 are in line with BNB's policy for gradual lifting of administrative measures on credit growth, in particular for more precise credit risk measurement.

**BNB continued its intensive efforts towards implementing the European banking standards.** Proposed Ordinance No. 8 on the Capital Adequacy of Banks was passed. When the new ordinance takes effect banks will be obliged to report in addition to previously regulated credit and market risk also the operational risk in their activity. Specific treatment of securitization schemes, collective investment schemes and credit derivatives is also envisaged. The new Ordinance No. 8 makes the capital adequacy of banks more transparent for market participants and bank service users.

*Insurance sector.* 2006 was marked by intensive changes in the regulatory framework of insurance towards harmonization of Bulgarian with European legislation. In particular, **the Insurance Code and its implementing legislation were passed at the end of 2005.** The peer review with representatives of the Council of Green Card Bureaux, which was conducted in October 2006 in order to verify Bulgaria's progress in meeting EU requirements, reported positive results. Thereby signing of the Green Card agreement for Bulgaria was confirmed but the timing of its implementation is not clear yet because of the lengthy process of ratification by all member states. The transitional period, characterized by eliminating

minimum tariff levels, expanding the scope of the Third Party Liability Insurance, and intensified competition, is a serious challenge to the companies in the insurance sector. Problems concern the adequate tariffication of compulsory insurance and the higher prices on account of contributions to the Guarantee Fund.

**Further tax relieves have been adopted for savings in supplementary pension insurance and Life Insurance** in the passed Law for Taxation of the Personal Income of Individuals, 2007. New amendments aim to encourage long-term saving.

**The Bulgarian Risk Management Association (BRIMA) was established last year.** Its activity is focused on establishing the principles of professional risk management among Bulgarian enterprises and corporate clients of insurance products. The association was admitted in the Federation of European Risk Management Associations (FERMA).

Life Insurance remains the most rapidly developing insurance subsector, showing however a sustainable trend of slow down of growth. On the other hand, General Insurance registers accelerated growth in the third quarter of 2006. Positive developments are observed also in property and motor vehicle insurance, whereas income from financial insurance is decreasing.

*Capital market.* 2006 ended with **notable success for Bulgarian capital market development.** SOFIX did not only go up above the so-called psychological limit of 1000 points, it reached 1200 points. The newer and broader index - BG 40, doubled its value over less than two years, reaching 199.88 points at the last trading session for 2006.

Turnovers also register stable growth and market capitalization reaches BGN 15 m, accounting for 31 per cent of GDP. Over 2006, this index registers remarkable growth of 82 per cent. Optimistic is also the fact that even if growth slows down in the next two years, the standard of 60-70 per cent of GDP typical for the developed countries will still be achievable.

The expert community called 2006 “the year of initial public offerings”. The first initial public offering was successfully made in the last quarter of 2006. Trading of the shares of two other companies, which made IPO earlier in 2006, was launched. Such public offerings are vital for the exchange because their successful implementation and the active secondary trading of shares would prove to investors and big non-public companies that the capital market is a serious capital raising and profit making alternative. It is known that the Bulgarian exchange suffers from the absence of these two categories of subjects. On one hand, the absence of investors puts off big non-public companies and, on the other hand, the existing investment opportunities make new actors unwilling to enter the market. Therefore, gradual entry of the one type of subjects will increase the number of the other type of subjects and vice versa, thus contributing to stable and continuous growth in liquidity, respectively in efficiency.

**There is a need to place special focus on completing the market infrastructure,** as it has direct effect on growth opportunities. Of principal

↑  
Growing  
exchange indexes

↑  
Initial  
public offerings

importance in this respect is to launch a project for introduction on the market of a clearing institution and a central counterpart as it would largely facilitate market participants in respect of transaction closing and would contribute to market security. This in turn would guarantee that the capital market would not get more speculative because of increased liquidity and would strongly support its development. The introduction of such institution would facilitate also the start up of a derivatives market in Bulgaria, at some later time, of course, when liquidity is improved.

These projects should be viewed also in the context of **initiated integration of BSE – Sofia in the European exchange structure**, but certainly the time when, obviously, clearing of transactions will need to be introduced is coming close.

### Main Economic Sectors

*Energy sector.* The successful bidder in the competition for appointment of the principal contractor for the construction of Belene NPP was announced at the end of 2006. This is the Russian company Atomstroyexport which proposed a price of EUR 3.997 b. However, some important project-related questions remain unanswered. Why is the competition for appointment of contractor organized before finding a strategic partner and financing banks? Why the variant of building anew the two energy units was chosen instead of completing construction works based on existent facilities, which was the leading argument in developing the technical specification? Why only a month before joining the EU Bulgaria was rash to commit all its strategic energy supplies to Russia? **The true test for the project will be the process of finding a strategic partner and sources of finance.** The backstage link between the appointment of a project contractor for Belene NPP and the pre-term signing of new contracts with Gasprom does not produce benefits for the Bulgarian end users, which makes illogical the concessions that the Ministry of Economy and Energy has made under both projects. Units 3 and 4 of Kozloduy NPP are decommissioned from 1 January 2007. The national energy balance is secured with cold reserves. Under normal operation of existing capacities there should not be electricity supply restrictions. The latest amendments to the Energy Law provide more preferences and economic incentives for the generation of energy from renewable energy sources. The government policy in the sector is focused on encouraging development of wind energy production technologies. Additional financial incentives are provided for investments in wind power plants using new equipment. The long-term contracts with NEK for guaranteed buyout of the electricity generated from RES are also an important incentive.

Belene  
NPP  
↓

Lack of reforms  
in BDZ



*Transport.* In 2006, major developments in the transport sector concerned **road infrastructure improvement**, transport companies' preparedness for Bulgaria's EU membership, the privatization of Bulgaria Air, finalizing the

debatable concessions on Burgas and Varna airports and completing the long-drawn project for the expansion and modernization of Sofia Airport. **Restructuring and financial rehabilitation of BDZ and NC Railroad Infrastructure did not take place.** In 2006, both companies continued to operate at a loss, relying entirely on state subsidy. Railways' financial stabilization is a priority on Government's program but remains a problem which the administration cannot tackle. The business also suffers from BDZ's deteriorated condition. Lack of freight cars prevents the carrier from performing all orders. Concerning the infrastructure company reconstruction, strongest interest enjoys the option for grant of concessions on railway stations in big towns. The national flag carrier Bulgaria Air was privatized at the end of 2006. Balkan Hemus Group was appointed successful bidder in the competition. Considering Bulgaria Air's management in the past few years and its much delayed sale, the privatization is unsuccessful. Disorders and problems accompany the commissioning of the new track and passenger terminal of Sofia Airport. Shortage of time for testing and certification of the new navigation system for landing made it unusable at low visibility. Implementation of the project for modernization of the passenger terminal was delayed by over 16 months and can serve as an example of poor project management. A safeguard clause was invoked against Bulgaria on its aviation just a couple of days before the country joined the EU.

Growth in construction  
slows down



*Construction and real estate.* In contrast to the past few years when growth in construction was two – three times up on total economic growth, in 2006 it gradually slowed down to only 7.9 per cent in the third quarter. **Delayed growth in the second half of 2006** is accompanied by moderately pessimistic business assessments of the condition and short-term perspectives in the sector.

**In 2006, construction still attracts an increasing share of foreign direct investments to Bulgaria.** In the first nine months of 2006 investments in construction and real estate stood at over EUR 1.2 b. Industrial production of building materials enjoys stronger foreign investors' interest dictated by the high demand in the construction industry.

The special investment purpose vehicles (SIPV) sector is advancing. As of 30 September 2006 the number of new companies stands at 29, including 21 traded at BSE. In the first nine months of 2006 the assets of these companies are up over 2.5 times.

Amendments to the Law on Investment Promotion are under way. The State prioritizes incentives for industrial zones, high technology, manufacturing, education and healthcare. Access to state financial support will be expanded by lowering the minimum thresholds for investment value.

End of 2006 witnessed at last approval of the town plan of Sofia City Municipality. Its implementing regulations are pending approval. No trade-off was achieved on another debatable draft law - for the Black Sea Coastal Zone, scheduled for approval in 2007.

↑  
Internet access  
in enterprises

*High technology.* In 2006, information and communication technology (ICT) are coming in strong in the business of Bulgarian companies and in people's everyday life. According to NSI's annual survey, in 2006 some 89 per cent of Bulgarian enterprises use computers, including over 84 per cent having Internet access. The same is true for individuals – almost ¼ of households have computers and some 17 per cent have permanent Internet access.

The year 2006 was characterized by a dynamic Internet services market. Besides some small company mergers, there were also a couple of large projects which will have strong effect on the sector in the near future. In mid 2006 Alpha Finance Holding bought 50 per cent of the shares in Spectrum Net for some BGN 10 m and six months later the European investment fund CEE Growth Luxemburg Sicar S.C.A invested almost BGN 3 m in the Internet provider BOL.bg. The inflow of fresh investment to the market implies more aggressive entry of new and improved quality of existing services, to the benefit of Bulgarian users.

Tourism slows  
down



*Tourism.* In 2006, tourism development continues at a good pace, but with more moderate dynamics compared to previous years. In the period January – November, the number of foreign tourists is up 5.32 per cent on January – November 2005. The European Union is still the major market of Bulgarian tourist services. Tourists from EU countries account for over 52 per cent of total foreign guests. However, in 2006 the number of EU tourists registers negligible growth – only 0.48 per cent – against previous years.

In the period January – October 2006, revenues from international tourism are up 4.2 per cent against the same period of last year, to 1.8 b. It has to be noted, however, that in the first ten months of 2005 revenues were up 9 per cent on the same period of 2004, which confirms a **slow down of growth in tourism**.

The people employed in the Bulgarian tourist sector give positive assessments of the past 2006 and are optimistic about the future. The number of tourists is up, revenues from tourism increase. On the other hand, growth is far from the values registered until a few years ago, confirming the opinion that the summit years of Bulgarian tourism are passing.

This sector, which generates significant revenues for the Bulgarian economy, **still suffers from absence of adequate government policy** – lack of approved national strategy, problems with the State Agency for Tourism (changes in agency's management have unfavorable effect on sector's development); difficulties and failures in organizing national advertising; lack of education and training policy producing qualified staff, etc.

Optimistic expectations for tourism development in the next years are based on the opportunities opened up by European funds, on priority development of specialized tourism (spa- and balneal, rural, cultural, golf, hunting,



congress tourism, highlighting Bulgaria's authenticity, specific way of living and crafts, culture and traditions.



Increasing  
agricultural  
output

*Agriculture.* While agricultural **output increases, the relative share of agriculture in the national economy is on a steady downward trend.** Sector's development is underpinned by the preparation of Bulgarian agriculture to accede to the Common Agricultural Policy (CAP) of the EU and the regulatory measures taken in that light. Major focal points of action include building the Integrated Administration and Control System (IACS) and the Paying Agency within the State Fund Agriculture, setting up the veterinary border inspection posts, preparing farms to implement European standards and absorb allocated subsidies. Achieved results cannot tell yet whether the sector will be able to cope with the big changes after Bulgaria joins the EU. It is known that the Common Agricultural Policy is the most wide-ranging common policy, allocating the biggest amount of funds. Despite the restrictions which have been imposed on the country (in the first year Bulgaria will receive only 25 per cent of the funds for agricultural support allocated to the other member states) **some BGN 1 b will flow in the sector in 2007** along three main lines: direct payments, market support and rural development. Planned subsidies are windows of opportunity. How we will turn them to our benefit depends on agricultural producers' awareness and on the organization at central and local level. One should not forget that the European Commission provides very strict control of the spending of allocated funds. CAP itself is under reform and, despite of the strong opposition, European agriculture will have to go market. This means eliminating and gradually limiting different purchase quotas and subsidies, changing the principles of applying for funds, etc. This tendency should be reflected in the National Rural Development Plan and in the operational program for implementation of the 23 measures set in the plan.

### EU Structural Funds and Regional Policy

Lack of preparedness  
to absorb money  
from the Structural  
Funds



2006 was a crucial year for Bulgaria in the process of preparing the government, the business and the citizens to operate with European Union's structural funds. *The National Strategic Reference Framework* – the main documents outlining the priorities for absorbing the money from the European funds, has been developed and approved by the Council of Ministers. The 7 *operational programs* to the National Strategic Reference Framework have been elaborated. They focus on several priority areas – transport, environment, human resource development, competitiveness of the Bulgarian economy, regional development, improving the administrative capacity, technical assistance. Changes of planning region borders have been proposed in order to fulfill Eurostat's standards for the territorial units in the EU.

Preparation of the business and the citizens for full EU membership is going on. The sociological surveys conducted in the past year show that the

representatives of the Bulgarian municipalities and business are not well prepared to operate with the European funds. Major problems stem from lack of experience in EU pre-accession programs, poor awareness of the structural funds, lack of resources for co-financing of projects, absence of qualified experts.

Efforts to solve the problem of the financing of municipalities for implementation of European projects are going on. The set up of a national fund FLAG – a financial instrument for bridge financing of concrete municipal projects under the European funds, has proven an efficient approach. The fund is to be structured up and become fully operational. There is a need to take proactive measures to improve the awareness and enhance the capacity of municipalities, entrepreneurs and NGOs to absorb money from the EU structural funds.